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Trade Finance in Indonesia:
Structural Issues and Impact of the Financial Crisis

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March 2000

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Trade Finance in Indonesia:
Structural Issues and Impact of the Financial Crisis

1. Introduction

Ever since the beginning of the economic crisis, there have been numerous reports about the inadequate supply of trade finance in Indonesia. Many believe that the shortage of finance underlies Indonesia's anemic export performance and is the cause of the serious deterioration in imports over the past two years. As a result, the Indonesian Government and several of its trading partners have initiated special programs to facilitate the flow of trade finance. These programs attempt to address the follow problems:

- The inability of Indonesian banks to obtain confirmation for their import letters of credit;
- A reluctance on the part of foreign exporters to sell to Indonesian companies on normal trade terms;
- The difficulties of Indonesian exporters to purchase imported raw materials, and;
- The unavailability of pre-export credit facilities from local banks.

In spite of the large number of Government initiatives to solve the problem, there is still a severe shortage of trade finance today. The programs have had little success since they do not address the complex structural problems inherent in the market. By its very nature, trade financing encompasses multiple aspects of the corporate, manufacturing and banking sectors of a country. A functioning and well-administered legal system is also required to ensure the implementation and enforcement of accepted international standards. When any one of these components is weak, or bankrupt as in Indonesia, it is unrealistic to assume that trade finance mechanisms can function properly. One result is that Indonesian companies have been forced to seek innovative alternatives to the more traditional methods of financing the import and export aspects of their businesses.

2. The Collapse of the Banking System and the Crisis in Trade Finance

Trade financing is fundamental to the flow of international commerce and has developed over the years to include a sophisticated set of mechanisms that allow unrelated parties to exchange goods and services internationally, while minimizing risk.[2] The fact that international transactions often involve unknown parties, different currencies, and take longer to complete than domestic transactions, increases the risk of an international sale. Among these risks are the normal commercial risks for credit extended, and country risk which covers a broad spectrum of economic, currency, and political risks. These risks are even greater when loans are in one currency while the earnings to pay back the loans are in another.

[2] Over the years, banks and trading houses have developed a standard set of financial instruments designed to cover the most common elements of payment risk. These include: bills of exchange, letters of credit, bankers' acceptances, and other documentary collection instruments. The system has been formalized through international standards such as the Uniform Customs and Practices (UCP 400) regulations.

Prior to the financial crisis, trade financing in various forms was well established in Indonesia. A number of Indonesian banks, both private and state-owned, had well-established international correspondent networks with inter-bank lines of credit for trade financing. Indonesian importers and exporters had access to a wide variety of trade financing options, including import letters of credit, pre-shipment working capital loans, and post-shipment refinancing. Indonesian banks and corporations also had access to the large number of direct and derivative financial instruments designed to help cover foreign exchange risk, but these were often ignored. With the rupiah under a managed float, both borrowers and lenders believed that hedging their exposure was unnecessary. Two other features of the trade finance system were that: 1) although trade finance was readily available through the banking system, the cost was relatively high; and 2), Indonesia had developed few of the non-bank financial instruments that are available in other countries for financing trade.

The fragile foundations of the Indonesian banking system began to crumble with the contagion of the Asian financial crisis in late 1997. The unsound risk management practices of the banking sector and its corporate clients soon became apparent once the rupiah began to plummet. The depreciation greatly increased the cost of unhedged foreign currency loans (many based on refinancing import letters of credit) and forced many borrowers into arrears. In late 1997 and early 1998, many local banks defaulted on their letter of credit obligations to international correspondents. This led to suspensions in lines of credit and in the confirmation of new letters of credit by international banks. Even though Bank Indonesia eventually paid international banks some $1.2 billion in trade-related credit arrears, international banks have not yet reentered the market. As letters of credit matured during the crisis, they were not renewed or replaced with new L/Cs.

At the same time that international lines of credit dried up, Indonesia's domestic financial sector all but collapsed. This collapse was much greater than in neighboring countries because of the structural weaknesses inherent in the system. The concentrated ownership structure of commercial banks, the lack of enforcement of established prudential regulations, inadequate and compromised accounting systems, and a non-functional legal system all contributed to the high level of losses suffered during the crisis.[3] Compounding the problem is the fact that many traditional customers of local banks were related companies in the same corporate group. In the past, these companies relied heavily on the banking sector for finance and now represent the majority of the non-performing loans in their respective banks. They are no longer eligible for the type of concessionary and insider credit that they received in the past. Nor are they able to obtain finance from other 'non-related' financial institutions.

For most of the crisis, Indonesian banks faced negative interest spreads and continued to lose money. Although deposit and lending rates have come down, excessive levels of non-performing loans and high administrative costs still represent a debilitating drag on bank earnings. By the end of 1998, the level of non-performing loans had skyrocketed to exceed 85% of total credit extended, and the Indonesian banking system had a negative net worth in excess of $11 billion. International audits conducted in 1998 concluded that over 90% of all Indonesian banks were bankrupt and none met international, or even Indonesian standards for capital adequacy. As a result, Government was forced to close and/or takeover the majority of the nation's financial institutions.

[3] Many now believe, with the benefit of 20/20 hindsight, that even without the Asian crisis, there would have been failures in the Indonesian banking system during the past two years.

Table 1: The Indonesian Banking Crisis and its Impact on Trade Finance

Banking Problem	Impact on Trade Finance
Since August 1997, 64 commercial banks are closed by Bank Indonesia.	Availability of trade finance is greatly compromised since many closed banks had previously extended liberal levels of trade credits—often to related companies within the same industrial group.
85% of the surviving commercial banks are small and do not have, or have lost, international bank correspondent networks. Many do not have foreign exchange licenses.	Small banks are unable to open internationally accepted import L/Cs or provide sufficient levels of credit to finance exporter requirements.
Few of the remaining state and recapitalized private banks are able to provide international trade services. They still suffer from severe structural problems that limit new credit advances. In the case of the recapitalized banks, an average of 85% of earning assets are now represented by government recapitalization bonds, which are non-negotiable and provide barely enough interest income to fund interest expenses on deposits.	The new state bank, Bank Manderi, has only recently started to open letters of credit for importers. BNI and several recapitalized private banks report that they are not accepting financing requests from customers that have no prior relationship with them. These banks have significantly decreased their trade finance activities and growth prospects appear slim. Credit terms from all banks are now more restrictive and expensive. Collateral requirements preclude many importers who can no longer qualify for finance.
Foreign and joint-venture banks lower their country exposure limits for Indonesia. Banks downgrade the creditworthiness of many trade- related businesses.	Foreign still involved with trade finance now require the guarantee of Bank Indonesia before accepting import L/Cs. With few exceptions, trade finance from these banks has been curtailed.
Several of the larger private banks that previously extended trade credit are now under control of IBRA (BTO category) and are too illiquid to extend new trade financing facilities.	Under IBRA rules, these banks are not allowed to extend new credits without submitting to a lengthy review and approval process by IBRA management. Existing customers of these banks, who have outstanding debt or are related parties, are not allowed to receive new credit extensions. New trade financing from these banks is virtually non-existent.
In a reversal of past policies, banks must now report off-balance sheet contingent liabilities, such as L/Cs, guarantees, and acceptances using international standards, and include them in the calculation of their Capital Adequacy Ratios (CAR) and risk reserves.	This causes already weak banks additional problems since all letters of credit (with few exception) are now risk weighted at 50% of their value. One reason that many banks require 100% cash collateralization for import L/Cs is to avoid further deterioration of their CARs.

The Indonesian banking crisis was a huge shock to the entire financial system and resulted in the virtual disintegration of trade financing mechanisms. Indonesian banks became either reluctant, or unable, to lend for trade purposes; and there was a severe contraction in the volume of off-balance sheet liabilities for letters of credit and bank acceptances. During 1997, total outstandings for trade finance remained fairly steady at around $13 billion (Table 2). As the crisis began to hit in the fourth quarter, there appears to have been an immediate cessation in the opening of new import letters of credit and a concurrent refusal to accept new import drafts. Since these instruments are usually opened for a period of 90 to 180 days, there was a delay between when the crisis hit and when the impact was felt on the amount of outstandings. By the first half of 1998, total trade instruments outstanding had fallen 50% to $7 billion. They have since fallen another 50% to under $3 billion in the third quarter of 1999.

Table 2: Indonesian Import Letters of Credit and Drafts Accepted

(In US$ billions)

Total Banks	1997				1998				1999		
	I	II	III	IV	I	II	III	IV	I	II	III
Outstanding Irrevocable L/Cs	8.2	7.6	8.0	6.6	2.9	3.2	2.2	2.1	1.9	1.5	1.9
Import Drafts Accepted Under Usance L/Cs	4.8	5.4	6.6	6.7	3.7	3.8	2.1	1.8	0.9	0.9	0.9
Total Outstandings	13.0	12.0	14.6	13.3	6.6	7.0	4.3	3.9	2.8	2.4	2.8

Source: Bank Indonesia. Data excludes 7 banks frozen since 4/98, 3 banks since frozen 8/98, and 38 banks closed since 3/99.

As a result of the financial crisis, Indonesian importers now confront a number of impediments, including the inability to open import letters of credit, cancellation of the normal working capital lines of credit necessary to finance inventories and receivables, and a shortage of foreign currency for international purchases. Those banks still willing to lend now do so only under very restrictive terms and at higher cost. The very thin foreign exchange market, in which minimal currency trades can affect the exchange rate significantly, has greatly increased the risk of default on import letters of credit and driven banks to seek pre-paid cash collateral. In order to provide cover against further depreciation of the rupiah, collateral requirements on dollar-based L/Cs are now as high as 125% in rupiah equivalent.

Exporters are hampered by inadequate finance to fund work in process or finished goods prior to shipment. Even those companies with competitive export products are hard pressed to take advantage of new opportunities unless they have well-established trade contacts or bank relationships overseas. Exporters that require imported raw material inputs face additional problems in opening letters of credit and in obtaining confirmation of those credits overseas. The simultaneous collapse of the Indonesian banking system and the drying up of new working capital loans from local sources is now seen by many exporting companies as the primary reason that they are unable to expand exports, in spite of the rupiah depreciation.

The Crisis in Trade Finance

LOCAL CURRENCY SUFFERS A MASSIVE DEVALUATION
perceptions of country risk and local bank risk increase ➘
company/commercial risk increases ➘
open account sales decline ➘
many trade-related companies default on outstanding credits ➘
overseas sellers demand letters of credit from prime banks ➘
local banks default on letter of credits ➘
international banks cut back on direct and documentary credit exposures ➘
terms and conditions on letters of credit become more restrictive ➘
interest rates and L/C fees increase ➘
local banks fail, survivors illiquid and unable to extend new credit➘
importers unable to open new letters of credit ➘
exporters unable to obtain pre-shipment finance ➘
new trade finance credits limited to fewer corporations ➘
local trade activities move to a cash basis ➘

3. The Trade Finance Programs of the Indonesian Government

The Government of Indonesia has developed several trade finance initiatives to address what it perceives to be the primary problems in trade finance (Table 3). The Government's initiatives address two main problems:

- The unwillingness of international banks to confirm letters of credit opened by Indonesian banks, and;

- The reluctance (or inability) of domestic banks to open import letters of credit or provide pre-shipment export credit.

These programs have been very much targeted at supporting exporters. Support for importers has been restricted to those companies that produce primarily for export. In most cases, the companies must produce an export letter of credit opened in their favor by an 'approved' international bank or an 'acceptable' purchase order for their product prior to obtaining financial support for importing inputs.

The Trade Maintenance Facility. The Government's most important program for international confirmation of Indonesian letters of credit is the Trade Maintenance Facility (TMF). This program originated under the Frankfurt Agreement of July 1998, whereby Bank Indonesia paid international banks some $1.2 billion in letter of credit and other trade-related arrears of local banks. In return, international banks agreed, on a 'best efforts' basis, to reopen their trade lines of credit with Indonesian banks and to confirm new import letters of credit under a back-up guarantee from Bank Indonesia.[4]

[4] At the time of the Frankfurt Agreement, there were numerous complaints from the local banking community about the 'preferential' treatment afforded to international banks. International banks received cash settlements from the government, while local banks were unable to collect on their own trade advances.

Table 3: Government of Indonesia Trade Financing Programs

Program	Source	Amount	Status
Guaranteed Letters of Credit			
Trade Maintenance Facility for guarantee of import letters of credit	Bank Indonesia	US$ 2.4 billion in committed lines	US$ 1.4 billion over 18 months. New guarantee only available when MOF back up to BI is in place.
Deposit Placement Fund to guarantee import letters of credit	Bank Indonesia	US$ 1 billion in deposits in 12 international banks	Approx. $855 million over 2 years
Working Capital and Trade-related Finance			
Pre-shipment financing	Bank Indonesia	No limit set	Approx. US$ 575 million*
Insurance guarantee scheme	PT Askrindo and Bank Indonesia	No limit set	Minimal since program inception late 1998*
Trade Finance Facility	JBIC / Japan	Yen loan for equivalent of US$ 1 billion	Zero as of 12/1/99. The facility is still being revised and will now be run through MOF and on-lent to Bank Ekspor
Rediscount of trade bills	Bank Indonesia	No limit set	US$ 1.8 billion over 3 years*
Usance Export Bills of Exchange	Bank Indonesia	No limit set	US$ 3.7 billion over 3 years*

* Under the new central bank law, Bank Indonesia will be required to discontinue direct lending and rediscount programs as well as direct guarantees.

Initially, Bank Indonesia entered into some 75 separate TMF agreements with international banks. Many of these were joint-venture banks or local representative offices of foreign banks operating in Indonesia. The agreements were for a one-year period, but LCs opened before an expiration date are guaranteed for a period up to 180 days after that date.

Historically, trade has been too important to a nation's economy and only a few countries have ever defaulted on LCs opened by their domestic banks. The TMF is absolutely necessary if international banks are to return to Indonesia, but the program has not met expectations. At its peak, guarantees under the TMF were less than 50% of the US$ 2.4 billion in lines of credit originally committed by international banks. Furthermore, TMF contracts were not renewed as they matured in 1998 and 1999, and there was a sharp decline in usage during the first 9 months of 1999. Total outstanding L/Cs under the guarantee decreased from US$ 1.1 billion in January 1999 to $686 million on 30 September 1999.[5] The decline may actually become much worse since most letters of credit are opened for 90 to 180 days. If no new L/Cs were being opened during the period, the decline in outstandings will be even greater in future months.

[5] A large number of banks still have outstandings under the program; but given the small totals for each bank, the LCs under the guarantee may be few in number and cover only a few large shipments.

Bank Indonesia is in the process of renewing TMF agreements with those banks still willing to participate in the program. The main cause for the protracted delay is the recent change in the central bank law which prohibits Bank Indonesia from extending sovereign guarantees directly to international banks. Consequently, Bank Indonesia is in the process of obtaining a 'back-up' guarantee from the Ministry of Finance. This guarantee will be a budgeted item to the extent that the MOF will provide BI a security deposit of approximately $50 million against future claims.

The reluctance of international banks to participate in the TMF and the decline in outstandings could be due to several factors.

- The Bank Indonesia guarantee is not sufficient to mitigate 100% of the increased Indonesian country risk caused by the unstable financial and political environment of the past two years. Consequently, the home offices of international banks have reduced their country exposure to Indonesia.

- The number of import L/Cs opened by Indonesian banks has decreased either because of bank closures or because the banks are unable to continue normal business due to liquidity, CAR, or other lending restrictions;

- Indonesian companies are unable to obtain financing because of past due debts, poor business prospects, or a generally decreased level of creditworthiness;

- The demand for trade financing has declined because of reduced sales of imported goods on the domestic market.

The Bank Indonesia Deposit Placement Fund. In 1998, Bank Indonesia negotiated separate agreements with 12 international banks and placed over US$1 billion in foreign currency deposits in those banks. These funds were to be used as a guarantee fund in case of default on Indonesian import L/Cs and were an additional incentive for the overseas confirmation of those LCs. The program was available to a pre-selected set of exporters (approximately 750 in all) who met the eligibility criteria of Indonesia' export facilitation program (PET). But the program was targeted at only one aspect of the problem and did not cover the broad range of financial needs of Indonesian exporters. It provided no new financing and no incentives for Indonesian banks to open letters of credit. Although aimed at exporters, the program was used mainly by Bulog and Pertamina for imports of basic foods and oil. Thus, Bank Indonesia is apparently discontinuing the program.

Pre-Shipment Export Credit Guarantees. The Government's first program to address the shortage of working capital was a fund of about US$500 million, which was used to provide partial guarantees, on a loan-by-loan basis, for pre-shipment credits offered to exporters by domestic banks. The program was to be a temporary measure designed to help companies build up cash surpluses through exports and for enabling banks to restore normal lending relationships. The program was not successful and usage was minimal because of administrative bottlenecks, high costs, and the fact that the local banking system had all but collapsed. The program was discontinued with the establishment of Bank Ekspor Indonesia in September 1999 (see below).

Real Sector Activation Scheme. The "Real Sector Activation Scheme" was introduced in September 1998 by a joint decree of Bank Indonesia and the Ministry of Finance. It is administered by PT Askrindo, a 100% state-owned credit insurance company.[6] The program is designed to overcome one of the problems of previous programs and offers domestic banks partial guarantees against default by borrowers. The insurance covers two types of risks: a) payment default under an import letter of credit; and b), payment default on working capital finance and pre-shipment export finance. The program has the following restrictions:

- Insurance coverage is limited to 80% of the value of import L/Cs or working capital loans;
- As an insurance program, no new funding for export finance is provided;
- Only import letters of credit for products destined for re-export as finished goods are eligible;[7]
- The program does not provide blanket approval for policies requested by an 'approved' bank. Instead, PT Askrindo is involved with the approval of each transaction.

Since it creation in 1998, the Real Sector Activation Scheme has seen only minimal usage. At the end of October 1999, there were 51 policies outstanding for a total value of Rp. 123 billion. This is insignificant in terms of Indonesia's total trade. Furthermore, all of the policies were written for a single bank.

According to PT Askrindo, the program is "not working" and usage is unlikely to increase while the banking sector is nonfunctioning. The insurance coverage provides local commercial banks with only partial guarantees against the risk of default by borrowers. Since loans under the program count against bank liabilities and since the banks are still in the process of improving their capital adequacy ratios, they have been unwilling to extend loans under the program. The banks may also mistrust the Government guarantee (because of the Bank Bali case).[8]

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[6] PT Askrindo was established in the early 1970's and acts primarily as the government’s agent for credit insurance in support of various SME and rural finance programs. Two state-owned insurance companies have recently announced that they will offer insurance coverage to small and medium-scale exporters for losses related to export payment risk and loss of goods in transit. PT Asuransi Jasaraharja Putra and PT Asuransi Export Indonesia (ASEI), which has several years experience with pre-export finance guarantees and insuring SME exporters, have signed a memorandum of understanding to provide a joint insurance package to selected exporters. Although this type of insurance may be useful to some exporting companies, the program does not represent a broad solution to Indonesia’s trade finance problem.

[7] This restriction is more severe than it might seem. Many Indonesian manufacturing companies may be unable to provide a clear link between their imported inputs and their exports of finished goods. Often, imported raw materials constitute only a small percentage of the value of the export product, and may even be purchased from domestic suppliers. Also, there can be a considerable time difference between the import of raw materials and the export of finished products.

[8] The poor reputation of PT Askrindo may also explain the low level of program usage.

Private Sector Initiatives

A promising new export program is in the process of being finalized by an international bank and two international financial institutions (the IFC and FMO). The program provides import and pre-export financing, as well as internationally accepted letters of credit. Risks are to be shared equally (33%) by each financial institution. The facility will be available for the importation of raw materials used in manufacturing exports and for the export of agricultural commodities (e.g. crude palm oil, coffee, and spices). Total funding is US$ 120 million and is available for transactions of at least US$5 million.

The IFC and FMO have agreed to use the Singapore office of the international bank in order to minimize their direct risk exposure to Indonesia. The underlying credit risk is still on the Indonesian company, but the country risk is reduced because the export proceeds must be paid directly to the off-shore bank. The local joint venture bank will act only as an agent and relationship manager for each transaction. It will not have any credit exposure on its local books.

4. Bank Ekspor Indonesia

Under Indonesia's new central bank law, Bank Indonesia will no longer have the authority to act either as a funding source or as a direct guarantor for the various trade finance programs in existence. As a result, the government established a state-owned export credit agency -- PT Bank Ekspor Indonesia (BEI) – to replace Bank Indonesia's role as the prime government agent for supporting trade finance. BEI's main mission is to consolidate and further 'enhance' existing efforts to revive export-related trade finance. Under normal circumstances, an export/import bank of this type primarily provides long term financing for buyers of a country's capital good exports, while short-term pre and post shipment export finance is provided by commercial banks. The rationalization for the creation of BEI is that normal conditions do not exist in Indonesia and that an alternative institution is required to meet the immediate needs of exporters for short-term pre-shipment and working capital credits.

Bank Expor Indonesia has the following mandates:

- To increase the availability of export financing through funding facilities, insurance, and credit guarantees;

- To provide pre-shipment and working capital finance, or guarantees, for exporters and for importers who are producing export products;

- To provide credit to, or guarantees on credits received by, overseas purchasers of Indonesian exports;

- To provide insurance coverage for the risk of non-payment in export transactions;

- To open and facilitate confirmation of import letters of credit for exporters;

- To participate in companies (*make equity investments?*) involved in developing Indonesian exports;

- To take over the role of Bank Indonesia as a supporting institution for export financing;
- To consolidate the administration of all export-import financing programs of the Indonesian Government and of donor institutions;
- To serve as a central information center for export-import financing.

BEI was formed under a special set of government regulations and operational permits, but is still awaiting approval of a new banking law that will approve its unique status as a specialized financial institution. The bank is to be primarily an indirect lender to exporters. It is not to compete with commercial banks, but will co-finance exporters with the banks and may take on a portion of the credit exposure and financial risk of exporters directly. This method of 'two-step' lending will likely raise the cost of loans to the ultimate borrower, since BEI must factor in its overheads, risks and ROA targets. Even so, BEI-sourced credit should be less expensive than if the commercial banks were to provide funding from their own deposit base.

The ability of BEI to become an effective vehicle for revitalizing trade finance very much depends on its obtaining adequate funding. The initial capital base of Rp. 3 trillion, which is to be received as a government deposit in phases as BEI's asset base expands, appears small. The current level of paid-in capital is believed to be the rupiah equivalent of approximately US$100 million. Since BEI is not supposed to 'compete' with the local commercial banks, it cannot mobilize deposits from the public. Thus, the bank will continue to depend on the Government or on other financial institutions for its funding base.

A long anticipated US$ 1 billion loan from the Japan Bank for International Cooperation (JBIC) may be critical to BEI's success. Originally, this facility was to be used as a guarantee fund, rather than as a direct source of credit funding. The loan proceeds were to remain in 'approved' international banks in Japan and were to be used to support Government of Indonesia loans and guarantees that were processed through Bank Indonesia.

The terms and conditions of the facility have recently been revised to accommodate the change in Bank Indonesia's status. The loan funds will now be available through Bank Ekspor Indonesia, and the loan will be managed by the Ministry of Finance. More importantly, the facility is being changed from a guarantee fund (primarily in support of Japanese affiliated companies) to a direct credit facility that will be available to all Indonesian exporters. The facility will have two components:

1) $300 million for direct financing of exporters, and;
2) $700 million as a fund to 'guarantee and finance' import letters of credit covering raw material imports for export products.

It is perhaps too early too say whether a government agency devoted entirely to trade finance will do much to solve Indonesia's problems. But the results to date are not encouraging. Even though BEI has been in existence for several months, it has been able to channel just $5 million worth of loans through one bank to four companies. None of the BEI programs address the real structural problems facing the Indonesian banking sector. As with other trade finance programs, banks may be unable, or unwilling, to take advantage of BEI facilities.

5. The Trade Finance Programs of Indonesia's Trading Partners

A number of Indonesia's trading partners have also introduced export guarantee programs to facilitate trade with Indonesia. Total committed lines of credit amount to approximately US$2.5 billion, but actual utilization has been extremely low (Table 4).[9] These programs were designed primarily to support the limited range of products that Indonesia's trading partners wish to export, and not what Indonesian exporters need to import.[10] Also, local banks participating in these programs must bear all commercial risk. As a result, usage has been severely hampered by the reluctance of local banks to extend either trade or working capital finance to Indonesian firms.

The programs have a large number of restrictions that limit their use. The most common are:

- Virtually all bilateral trade finance programs are tied to exports from the home country, where these exports are subject to local content rules;

- Many of the programs are restricted to surplus products in the exporting country (such as agricultural products) and do not include the raw materials that Indonesian exporters need to import (cotton being one exception).

- A number of programs include 'adverse impact' clauses, which prohibit the processing and re-export of the product to the exporting country. This limits the use of the programs by some Indonesia export companies that have a high dependency on imported inputs (e.g. garments);

- All programs require some form of Indonesian government guarantee, which adds significantly to the administrative burdens of the programs;

  Official export programs do not cover commercial risks. These are borne by local banks, which may then be unwilling to open import letters of credit without substantial collateral.

- Most bilateral programs are structured with a very complicated set of cross-default clauses, which often place financial institutions into the political arena. For example, alleged abuses of human rights, environmental standards, or labor rights can cause an exporting country to suspend or cancel its official trade finance facilities. Payment clauses can be invoked, requiring local financial institutions to immediately repay outstandings for reasons other than financial default.

- Most programs are transaction guarantees or insurance schemes that cover less that 100% of the political, commercial, or banking risks associated with trade. They do not provide new funding or inject liquidity into the system. As a result, they are of no use to exporters who are in need of working capital.

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[9] This estimate does not include the US$ 1 billion available from the Japanese Export Import Bank. Although available since 1998, this facility has never been drawn upon. As mentioned earlier, the facility is being revised.

[10] The trade programs of many official export credit agencies were already in place before the financial crisis, but were usually targeted towards 'big ticket' infrastructure projects.

- Many programs restrict availability to pre-approved local banks or local branches of home country banks. This has caused many administrative problems in the past since some "approved" banks have failed and since it takes time for newly formed banks to be added to the list of approved banks.

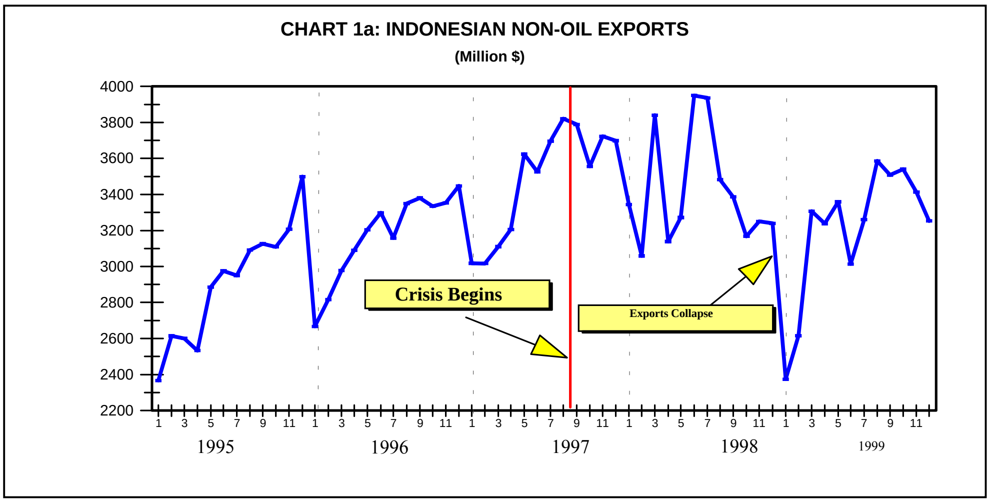
Table 4: Bilateral Trade Financing Programs For Indonesia

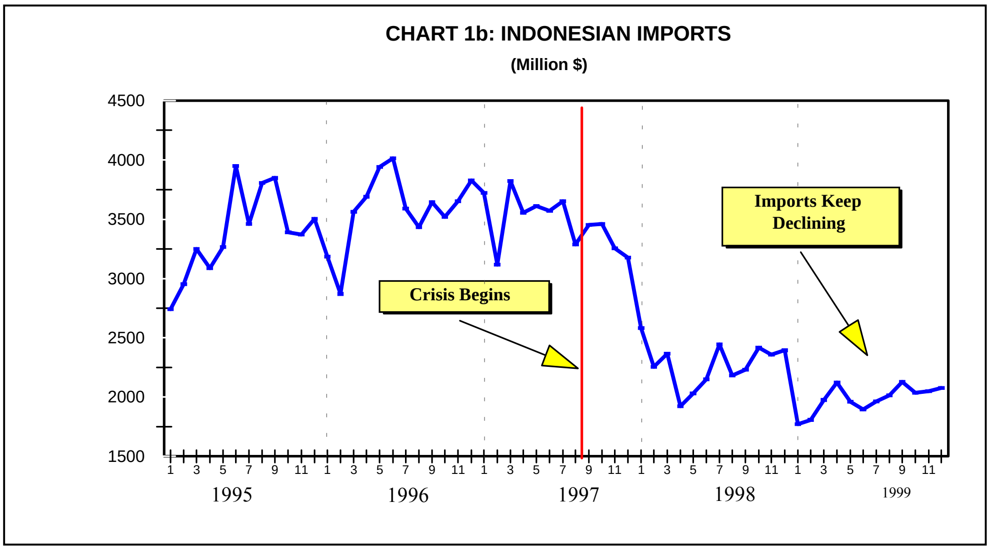
Program	Source	Amount	Status
Guaranteed Letters of Credit			
Export Guarantee Fund and financing scheme	EFIC—Australia	US$118 million and A$ 1.5 million	Approx. US$ 14.7 million over 2 years. Reported as discontinued in late 1999.
Enhanced Export Guarantee and Financing Facility	US Exim Bank	US$ 1 billion	0--as of 6/30/99
USDA agricultural product export program	GSM-102—USA	US$ 400 million	US$ 91 million. Suspension of program recently lifted
Trade Financing Support Facility for agricultural imports	GSM—USA	US$ 24 million guarantee for 80% of import L/C value with max. of $8 million per any one L/C	0--as of 12/1/99
Guarantee for wheat imports	Canada Wheat Board	C$ 250 million	US$ 36 million over 18 months
Other Bilateral Programs [All of these programs are reported to be either in the process of negotiation or are in abeyance pending positive changes in Indonesia's country risk profile. There have been no disbursements under any of the programs.]	1. KfW / Germany 2. Canada 3. Holland 4. China 5. ECGD / England 6. ITFG / Singapore	6. DM 250 million 7. C$ 20 million 8. NLG 250 million 9. US$ 200 million 10. Lbs 100 million 11. US$ 2 billion	

6. Indonesia's Trade Performance During the Crisis

Large currency depreciations such as that experienced by Indonesia during the economic crisis should give a big boost to exports within one to two years after the depreciation. Yet, it is now more than two years since the crisis began and Indonesia's export performance has been anemic. Furthermore, exports collapsed at the start of the fall buying season in the second half of 1998 and showed almost no sign of recovery in 1999 (Chart 1a). For the first 9 months of 1999, non-oil and gas exports were down 9.1% over the same period of the previous year.

The situation with Indonesian imports is even worse than with exports. Imports began to decline immediately when the crisis began, and were about 60 percent of pre-crisis levels throughout 1998 (Chart 1b). About two-thirds of Indonesia imports are spare parts and industrial raw materials that are used for processing by Indonesian industries. Because of the lead time between the date raw materials are imported and the date finished goods are exported, imports serve as an indicator of future exports. As of yet, however, there is no sign of a recovery in imports. Rather, imports for the first six months of 1999 were even lower than in 1998.





There has been abundant anecdotal information on why Indonesia exports have been performing poorly. Among the problems mentioned in the press are the lack of trade finance, shortages of containers, and supply disruptions. *But probably the single most important factor causing Indonesia's weak export performance has been declining international prices.* After deflating by prices, Indonesian exports appear to have been increasing at a healthy pace through mid-1998 when they went into decline for about six months.[11] *In March of 1999, real exports recovered to above pre-crisis levels.* This is in contrast with nominal exports which have fallen back to levels of 1996.

[11] The export price index used for this analysis is a Laspeyres index based on export unit values. There are many problems with the underlying data used to construct the index and it is very unreliable as an exact measure of price changes. But it probably does serve as a good indicator of the general trend in export prices.

The decline in U.S. dollar prices for Indonesian exports appears to have occurred in all sectors. In the case of natural-resource-based products, international prices had been depressed for several years and declined even further as a result of the regional slowdown in Asia. Such declines account for all of the negative growth of Indonesia's natural-resource-based exports during the past two years (Table 5).

Table 5: Summary of Indonesia's Export Performance During the Economic Crisis

	Exports		Export Situation 1998 Versus 1997		Export Situation First 6 Months of 1999 Vs. First 6 months of 1998	
	1997 (Million US$)	1998	Export Growth	Change in Export Prices	Export Growth	Change in Export Prices
Total Non Oil/Gas	**41.6**	**40.8**	**-2.4%**	**-13.6%**	**-12.4%**	**-13.1%**
Minerals and Mining	**3.9**	**3.5**	**-10.9%**	**-20.5%**	**1.5%**	**-12.1%**
Agriculture	**8.1**	**7.3**	**-10.1%**	**-11.8%**	**-6.8%**	**-14.1%**
Forestry	**6.8**	**6.1**	**-9.7%**	**-30.0%**	**-3.3%**	**0.5%**
Other Manufacturers (Non-Resource Intensive)	**22.0**	**23.3**	**5.9%**	**-8.6%**	**-17.2%**	**-17.9%**
Other	**0.8**	**0.5**	**-36.1%**	**N.A.**	**-48.7%**	**NA**

More surprising is the apparent, substantial decline in export prices for Indonesian manufacturing goods. Prices for manufacturing goods are generally sticky in the downward direction; but in 1999, the decline in manufacturing prices (-17.9%) was almost identical to the decline in manufacturing exports.

There are several possible reasons for the decline in U.S. dollar prices for manufacturing goods. First and foremost, domestic demand was severely depressed by tight monetary conditions early in the crisis and as a result, some exporters shifted sales from the domestic to international market. In order to expand overseas sales, they probably had to undercut existing prices – perhaps because of lower quality. Second, Indonesia exporters sell primarily on an fob basis and few market their products directly abroad. Since depreciation of the rupiah has led to increased returns on a domestic currency basis, international buyers may have been able to garner part of those increases for themselves by demanding price discounts. Such price discounts may also reflect increased risk premiums for doing business in Indonesia, since international buyers have reportedly been concerned that orders from Indonesia would not be met because of political instability.

Another factor that could have caused recent declines in exports is the appreciation of the exchange rate. After falling from 2300 to 15,000 Rp/US dollar during the first ten months of the crisis, the rupiah began to appreciate in July of 1998 and reached 6700 in June of 1999. This was the month in which Indonesian exports began to decline. Furthermore, the competitive benefits of Indonesia's depreciation have been gradually eroded by inflation, which was about 200 percent between June 1997 and June 1999. In real terms, therefore, the depreciation of the rupiah since the beginning of the crisis has been about 35%. Although this is still substantial, some exporters claim that with the upturn in domestic demand and appreciation of the rupiah, it has become more profitable to sell on the domestic market than on the export market.[12]

7. Trade Finance and Other Factors Influencing Exports

As indicated earlier, the collapse of the domestic banking system has caused a tremendous deterioration in the amount of trade financing available from Indonesian financial sources. This deterioration is often mentioned as a serious problem for Indonesian exporters, and continues today in spite of the large number of bilateral and Indonesian Government programs that have been introduced to solve the problem. A wide spectrum of Indonesian trade activities could be affected; and to the extent that trade finance outstandings cover raw material inputs for future exports, an export led recovery from the crisis is very much in doubt. But it is quite difficult to draw concrete conclusions regarding the impact of the trade finance problem on Indonesia's exports.[13]

First, the total decline in trade outstandings during the crisis was about $11 billion (Table 2). Even with a payment cycle as long as 6 months, the total amount of trade affected by this decline would be as much as $22 billion. Yet, the actual decline in Indonesian trade, either imports or exports, has been nowhere near this amount. It can therefore be inferred that many companies are still able to operate on an open account basis or are receiving financial support from outside the Indonesian financial system.

Second, Indonesian imports of raw materials are used not only in the production of export commodities, but also for commodities produced for the domestic market. A sharp decline in imports consumed domestically can be expected because of the higher rupiah prices caused by the depreciation. Even for exported commodities that previously relied on imported inputs, there may have been some substitution to raw materials produced domestically.[14]

Third, the decline in trade finance outstandings may be due not only to the failure of commercial banks, but also to the financial condition of the trade-related corporate sector. There are now some 45,000 companies, ranging from very small companies to large conglomerates, that are involved in some form of trade and that fall under the influence of Indonesia's Bank Restructuring Agency (IBRA). The loans of these companies have been transferred to IBRA, either because their existing debt is in arrears and has been classified as a loss by international auditors, or because the bank which placed the loan is now under IBRA management. Such companies are severely compromised in their ability to obtain new trade financing without IBRA approval. IBRA is not a lending source and has been very selective in approving loan extensions from banks under its control. As a result, many

[12] Some exporters were complaining of lack of competitiveness before the crisis when many believe that the exchange rate was overvalued by 10 to 20 percent. If this is the case, appreciation of the rupiah below 5500 to 6000 rupiah per U.S. dollar could cause major problems for exporters.

[13] Data on the type or amount of trade financing associated with a given level of trade is unavailable. Trade data are based on declaration forms submitted to customs when goods are actually imported or exported. There is no corresponding information regarding the types of financing or documentary credits associated with particular shipments. Trade financing statistics are maintained by individual financial institutions and are reported monthly to Bank Indonesia.

[14] For export commodities, this substitution is likely to be small since exporters have always claimed that the quality standards demanded by their buyers required the use of imported raw materials.

companies are now faced with the impossible task of repaying all outstanding debt before they can secure new working capital or trade financing.

Corporate Debt and Exports. The impact of the corporate debt problem on Indonesian exports is difficult to determine. But it is likely that larger companies have been more affected than smaller companies. Small companies have traditionally been more reliant on a trust relationship between buyer and seller, and have relied less on formal trade finance facilities through the banking sector. They are also unlikely to have accumulated much foreign currency debt.

According to Indonesia's industrial survey, the largest 8% of Indonesian export companies, as measured by labor force, account for approximately 75% of total exports in the non-agricultural, non-oil and gas sectors. If large companies are more likely to have their activities curtailed by the debt crisis, export sectors dominated by such companies should be doing relatively worse than other sectors. This appears to be the case (Table 6). Export sectors dominated by a few companies have performed worse than sectors with many exporting firms. Exports from sectors dominated by a few large firms increased by 0.8 percent in 1998, compared with 3.6% for sectors with many exporters. Although exports from both sectors declined in 1999, the decline was much greater (-13.1%) for large company sectors than for small company sectors (-2.1%).

Table 6: Indonesia's Export Performance by Size of Company Exports

	Export Growth For Industries with Average Exports per Company	
	< $2.5 Million	>$2.5 Million
1998 on 1997	3.6%	0.8%
First 6 mos. of 1999 on First 6 Mos. Of 1998	-2.1%	-13.1%

Note: Table 11 includes forestry and manufacturing. Mining and agriculture are excluded.

IBRA has begun to categorize the companies under its control and is cooperating with Bank Ekspor Indonesia to develop a recovery program for those having good prospects. The two agencies intend to identify those export-related companies who have outstanding trade finance debt that can be restructured and perhaps refinanced through Bank Ekspor. Additionally, they intend to transfer, to the extent possible, the performing loans of exporters at one of the closed banks. IBRA will continue to work directly with those large exporters who are in need of debt restructuring so that they become eligible for new trade credit from recapitalized commercial banks or Indonesia's two state banks.

Exports and the Confirmation of LCs. Because of the increased risk of doing business in Indonesia, exporters to Indonesia are less likely to export on an open account basis and are more likely to demand a payment guarantee (e.g. confirmed letters of credit). Yet, the international banking system has cut back its exposure to Indonesia and is unwilling to confirm new letters of credit. If this represent a significant problem for Indonesia, those export industries that rely heavily on imported raw materials should be doing poorly.

In fact, industries with high import content seem to be performing better than industries with low import dependence (Table 7). In 1998, exports of high import-content manufacturing industries increased by 6.5%, compared with minus 0.9% for low import-content industries. In 1999, both types of industries experienced negative growth, but the decline for high import-content industries (-3.2%) was much less than for low import-content industries (-11.3%).

Table 7: Indonesia's Export Performance by Imported Input Content

	Export Growth For Industries with Imported Input Content ≥37 Percent	<37 Percent
1998 on 1997	6.5%	-0.9%
First 6 mos. of 1999 on First 6 Mos. of 1998	-3.2%	-11.3%

Note: Table 2 includes forestry and manufacturing. Mining and agriculture are excluded.

The above dichotomy can be explained in several ways. First, those exporters who wish to stay in business must make adjustments to overcome the problem. Interviews with Indonesian exporters indicate that many are financing their activities from internal capital (some by not paying back existing loans) or have arranged alternative forms of financing through their buyers or suppliers. Also, industries with high imported input content may have higher foreign ownership shares or licensing arrangements that allow them to obtain financing through their parent companies, or through their foreign partners.

Second, the shortage of bank trade finance is part of a general liquidity problem that affects all exporters, not just those that rely heavily on imported raw materials. Exporters are in need of finance for their entire operation: 1) raw material purchases whether foreign sourced or domestically produced; 2) pre-shipment financing which includes the working capital needed for the production and marketing cycle; and 3), post-shipment finance which might include financing for overseas buyers. Viewed this way, the shortage of trade finance can be a real problem, but it is one that affects all exporters. As noted earlier, those that rely heavily on raw material imports may in fact be stronger companies, affiliated with multi-nationals, and have alternative means to overcome the problem.

One indicator of the general lack of liquidity in the financial system is the total loans outstanding that are classified as working capital credits. These credits should be short-term in nature and cover the production and sales cycles of many businesses. Not all bank credits classified under this heading are trade-related, but the totals would include loans granted for the refinancing of import letters of credit, pre-export production costs, discounting of export letters of credit, and pre-shipment financing.

As indicated in Table 8, total working capital credits in rupiah declined by almost 35% between September 1998 and September 1999. Some of these credits, e.g. those of foreign joint venture banks, were probably denominated in a foreign currency. When the 'increasing effect' caused by the rupiah devaluation is neutralized, the deterioration in commercial bank credits related to pre-shipment/working capital transactions would be even greater.

Table 8: Outstanding 'Working Capital' Credits of the Indonesian Commercial Banks (Loans in Rupiah and Foreign Currency)

(In Trillion Rupiah)

Type of Bank	Sep-98	Dec-98	Mar-99	Jun-99	Sep-99	Change
State Banks	135.1	131.7	95.8	83.9	86.1	-36.3%
Regional Development Banks (RDB)	5.8	5.6	5.7	5.4	5.7	-1.0%
Private National Banks	166.0	154.7	108.3	48.8	46.9	-71.7%
Foreign & Joint Venture Banks	72.2	54.0	55.1	41.9	50.3	-30.3%
Total	379.1	346.0	264.9	180.0	189.1	-34.8%

Source: Bank Indonesia statistical reports

8. The Enabling Environment

Fundamental structural reforms are required to speed the recovery from the economic crisis and to lay the foundations for the more efficient delivery of trade finance in the future. Such reforms would allow importers and exporters to obtain properly structured trade credits and employ the full range of financial instruments available in today's international market. Some such financial instruments have been available in other developing countries for decades, but have seldom been used in Indonesia. Furthermore, there are examples of Indonesian regulations that run contrary to the standards of international trade financing.

Secured Transactions Law. First and foremost, there is a long-standing need to enhance the enabling environment for trade financing by introduce a law on secured transactions. Such a law has been on the administrative agenda for several years, but has never been passed. As a result, trade financing in Indonesia is hampered by a cumbersome and obsolete set of laws regarding the registration, transfer of title, and pledging of corporate and private assets. The net impact is that short-term trade credits must generally be secured with ‘hard assets’ unrelated to the trade transaction itself. A secured transactions law would enhance the future development of trade financing in Indonesia by promoting transactional based lending and reducing the need for outside collateral.

Recently, a law covering fiduciary transfers and the registration of secured assets was enacted. This law permits the registration of encumbered assets and thus contains one element of a secured transactions law, but it is a very poor compromise on what is really needed. The registration system uses an unmanageable notarial deed for all transactions and title transfers, and involves high transaction costs. Amendments to the deed must be made through an official notary office and are very difficult to effect since they require that an entirely new deed be issued at the time of change. More importantly, these notarial deeds are not blanket filings on a group of assets, but must specifically list each item to be registered. This leads to great difficulties in cases of partial sales of inventory, the exchange of pledged assets, senior rights of position among creditors, and the ability to verify exactly what assets remain registered in favor of each creditor.

In the case of trade finance, the current law is unclear regarding which, if any, of the standard international financial instruments and transaction documents can be used as security. This includes discounted bills of exchange, usance letters of credit, bills of lading, movable inventory, accounts receivables, and warehouse receipts. As a result, importers and exporters remain constrained in their ability to obtain financing using the standard international trade instruments as collateral. A comprehensive upgrade of the laws and regulations on secured lending would promote trade by reducing trade-financing risks and by lowering transaction costs. Such an upgrade should be based on international "best practices," such as the standardized set of procedures and regulations set forth under UNCITRAL.[15]

Bank Indonesia Regulations on Collateral. A problem similar to the above also occurs because of current Bank Indonesia regulations on the types of collateral needed for secured lending. In general, Bank Indonesia criteria are too heavily weighted towards securitized lending and are inflexible on what can be considered as acceptable collateral, or the value of collateral deemed appropriate for a particular type of credit extension. As a result, Indonesian banks require virtually all loans to be collateralized with real assets, cash, or personal guarantees--often with excessive loan to value ratios.[16] This type of secured lending is even more of a problem for small and medium enterprises since it ignores the 'risk coverage value' of non-real assets and any collateral standard inherent in the trade documents themselves. Most SMEs do not have the financial strength to provide the level of 'outside' collateral required.

In the case of import letters of credit, Indonesian banks require that the credits be secured with real assets not related to the imported goods. Those few banks still engaged in trade financing may even require greater levels of security, requiring importers to deposit more than 100% of the value of the letter of credit in cash. By requiring cash collateral, the banks avoid further deterioration of their already weakened capital adequacy ratios. Although L/Cs are an off balance sheet contingent liability, they usually carry a risk weighting of 50%, unless they are pre-paid and secured by a cash deposit. In the case of an L/C opened in a foreign currency, the banks require even more collateral to cover possible losses due to adverse exchange rate movements. Similarly, exporters have been required to secure their pre-shipment working capital credits with unrelated hard assets domiciled in Indonesia. In either case, the banks effectively give no value to the fact that an importer or exporter may have a firm purchase order, an export letter of credit, or goods in inventory pending export.

9. Alternative Trade Instruments

Over the years, a wide variety of instruments have been developed for facilitating the movement of goods and services internationally, while providing flexibility in the management of financial and commercial risks. Trade financing has developed simultaneously with a fairly standardized set of practices and procedures. The discounting of bills of exchange dates back to the Middle Ages. Bills of Lading and other shipping documents that convey title to goods in transit have been in use since the mid-1700s. Letters of credit, in their various forms, have evolved as standard instruments of international trade over a similar period of time.

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[15] UNCITRAL (United Nations Commission on International Trade Laws) has established a standardized set of policies and procedures for international trade, including the use of fiduciary transfers and the acceptance of certain negotiable instruments as collateral for trade financing. Over 70 nations have agreed to follow the standards set by the Commission.

[16] Recent international audits of Indonesian banks have revealed many striking exceptions to this practice. Insider lending, the overvaluing of collateral, and flawed documentation were common practices. It is also the case that many import letters of credit were opened for affiliated companies without regard to existing banking regulations or prudent lending practices.

As discussed above, a secured transactions law is necessary before Indonesian companies can take advantage of the full range of financial instruments now common in many other markets. Although letters of credit have been widely used in Indonesia for a number of years, they have rarely been used to secure trade-related credits. Bills of exchange have been discounted and traded in a very thin secondary market, but additional collateral has almost always been required. There are two other two other financial instruments that appear to have been seldom used, but which deserve further emphasis in the current context. These are the use of *forfaiting* as a direct substitute for commercial bank credit, which may not be revived for some time, and the use of *warehouse receipts* to secure trade credits. Special efforts to incorporate both of these instruments into Indonesia's financial infrastructure should be explored.

Forfaiting. In a forfaiting transaction, the debt due by an importer is purchased from an exporter without recourse to the exporter or previous holders.[17] This debt is usually evidenced by a series of negotiable financial instruments such as promissory notes or bills of exchange. Alternatively, the debt may take the form of a usance (deferred payment) letter of credit opened by the importer's bank. The notes or bills are usually guaranteed by a bank in the importer's country and, subject to the quality of the guarantor, become marketable amongst international banks and other financial institutions.

Once the importer's notes or bills are purchased, forfaiting companies may decide to place them with investing institutions. Notes may be sold immediately, held for an interim period to earn a yield, or held to maturity. Bills of exchange, promissory notes, deferred payment letters of credit, and other transferable financial instruments can all form part of a portfolio of forfaited assets.

There does not appear to be any legal impediment to the establishment of a private forfeiting house in Indonesia. Such a company would probably be considered a financial institution, and would then come under the supervision of Bank Indonesia and be subject to a minimum level of paid-in equity capital. Bank Ekspor is might play a more dynamic role in the recovery of trade finance by considering ways to facilitate the development of private sector forfeiting houses in Indonesia.

Warehouse receipts. Warehouse receipts are another type of financial instrument which are widely used for trade financing in other countries. Warehouse receipts are negotiable instruments of title that can be used as collateral by banks and which facilitate the exchange of goods, without the physical movement of those goods. They are the primary title documents for commodities traded on commodity exchanges, where the financing of future positions of producers, processors and exporters can be provided either by banks or by non-traditional financial sources such as insurance companies and pension funds. Another common use of warehouse receipts is as an instrument that allows farmers to extend their sales period beyond the harvesting season while obtaining short-term credit through the securitization of the receipt. The warehouse receipts are secure collateral for banks that extend credit to farmers against the value of agricultural products--sight unseen.

A simple warehouse receipt system can lead to a variety of credit structures involving both local and international banks. While an international bank may feel comfortable in extending

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[17] In English, the purchaser has forfeited his right of recourse to the previous holder; in French, the debt has been purchased "a forfait."

import financing only after the goods are in port, an efficient warehouse receipt system can allow the financing to occur at a point further up the supply chain. At the same time, exporters are able to obtain funding from local banks more easily using exportable goods secured under a warehouse receipt system. Because of the added security of having the goods in a warehouse and secured by a legally registered instrument, credit risks are mitigated and the local bank is able to extend credit at a lower rates.

A warehouse receipt system includes the warehouses that issue the receipts, the legal framework under which the receipts are negotiated and traded, and an inspection agency. There are a number of conditions that must be met for an efficient warehouse receipts system of finance to develop:

- A network of warehouses that are technically competent and financially strong;

- An appropriate legal and regulatory environment that allows warehouse receipts to convey title to the stored goods; and,

- A financial system of trading houses and banks that accept warehouse receipts as collateral against credit and are able to take possession of the commodities pledged in the case of financial default.

Currently, several banks in Indonesia and Singapore use Indonesian warehouse receipts in their trade finance operations. In the absence of enabling regulations, however, warehouse receipts in this context are only an additional piece of documentation in the credit process. They provide little collateral value. Most commonly, the receipts have been issued to banks that extend pre-shipment financing on goods in a public warehouse. Typically, the goods being financed must be pre-sold, which defeats one purpose of a warehouse receipts system; and in many cases, the loan to collateral ratio is as low as 50%.

There is a fairly well established network of warehouse facilities in Indonesian, including those controlled by government agencies such as Bulog. A government-owned supervision, inspection, and appraisal company, Sucofindo, is involved with warehouse management and the collateral control business. Sucofindo will issue a 'warehouse receipt’ that describes the kind, quantity, and condition of goods stored under its control, but it assumes very little legal liability for loss. Nevertheless, the foundations are in place for the development of a proper warehouse receipt system in Indonesia if the regulations on collateral and transfer of title are amended.

10. Conclusions and Recommendations

The Indonesian banking crisis has created a huge shock to the entire financial system and has resulted in the virtual disintegration of trade financing mechanisms. Local banks are now incapable of providing the level of trade financing required and are themselves considered uncreditworthy to obtain credit through their international correspondents, a vital component of trade finance. Compounding the problem is the fact that many traditional customers of local banks were related companies, belonging to the same corporate group. In the past, these companies relied heavily on the banking sector for trade finance and now represent the majority of the non-performing loans in their respective banks. They are no longer eligible for the type of concessionary and insider credit that sustained them in the past. Nor are they able to obtain finance from other 'non-related' financial institutions.

The total meltdown of the banking sector is at the heart of the trade finance problem in Indonesia. Most official trade finance programs introduced during the past two years are export credit guarantees or insurance plans that do not resolve the real problems faced by companies engaged in international trade. They all depend on a well-functioning banking system that can issue letters of credit, provide working capital financing, and take on some risk of default by Indonesian borrowers. The inability of the local commercial banking system to intermediate in trade finance due to its own structural weaknesses, combined with the retreat of most international banks from the Indonesian market due to increased country risk, are the primary reasons for the acute decline in trade finance.

The rapid recapitalization and prompt reentry of the local commercial banks into the trade finance markets is the key to the revival of the market. But even so, recovery of the banking system will take years, while trade financing requirements are immediate. Otherwise, *Indonesia's foreign trade activity will have relatively little impact on the economic and the* recovery will have to be domestically driven.

Official export credit facilities, government guarantees for letters of credit, and the bilateral trade lines designed to help secure financing for exporters are an important start. But they are not working in the current Indonesian environment. The new BEI and other official programs do not have the capacity to support Indonesian trade at current levels and any sustainable solution to the problem will require the re-entry of the international banks and the recovery of the local commercial banking sector. The donor community and multinational finance institutions could assist by providing additional untied import finance lines, and by extending direct country and banking risk cover to foreign commercial banks as an encouragement to restore inter-bank trade lines to Indonesian commercial banks. Additional financing facilities of about US$3-4 billion might be required to make a significant impact.

Although returning the local banking system to solvency is critical to the revival of trade financing in Indonesia, complimentary improvements in the legal and regulatory environment for trade finance are also needed. The institutional framework required for an efficient trade finance system does not exist in Indonesia. Foremost on the list of changes are the current Bank Indonesia regulations on loan structures and collateral requirements, which greatly impede the use of trade finance instruments by requiring that the banking system secure all loans with 'real' collateral, rather than trade documents. Current regulations effectively require excessive level of outside collateral by discounting any 'added value' from trade-related documents. A new law on secured transactions, which includes the basic concepts of trade finance through documentary credit, title transfer, and warehouse receipts, should also be developed. The local legal system must develop a reputation for fairly enforcing contract law so that international banks regain confidence that Indonesia can operate under internationally accepted standards for trade finance.

Recommended actions are as follows:

Table 9: Recommendations

TRADE FINANCE ISSUES	RECOMMENDED ACTIONS STEPS
The local banking system is non-functional and unable to extend trade finance to importers and export-related companies.	The government should continue its program to restructure and recapitalize the local banks, as well as provide support in the form of official guarantees. Some priority should be given to programs that assist banks in the re-opening of trade finance lines of credit to creditworthy exporting companies.
Current Bank Indonesia regulations state that to maintain a 'safe' level of classification, loans must secured by real assets. This creates an overly restrictive requirement for loan collateral against trade-related credits.	Bank Indonesia should undertake a review of all regulations which impact the ability of local banks to participate in trade finance activities using internationally accepted financial instruments. Changes in the definition of acceptable collateral should be introduced as required.
Most of the official government programs designed to support trade finance are not functioning efficiently. In general, they are overly restrictive and lack the coordinated effort required to achieve their goals.	The government should hold an inter-agency workshop on trade issues to determine the problems with the government guarantee programs and officially sponsored export credit and insurance programs. The review should determine which programs should be discontinued and which should be restructured. Many of the trade finance operations previously conducted by Bank Indonesia should be revised and transferred to BEI and/or private sector commercial banks.
Many export-related companies have significant debt problems and are in arrears on their past credits. Severely past due loans have been transferred to IBRA for collection. Viable companies need to restructure their debt as a pre-condition for obtaining new trade credits.	IBRA should identify those export companies that are strong candidates for debt restructuring and which have viable future business prospects. IBRA and BEI should form a working committee to develop a combined debt restructuring and new credit program for selected companies.

TRADE FINANCE ISSUES	RECOMMENDED ACTIONS STEPS
The current capitalization of BEI seems inadequate for a recovery in trade finance. To be an effective intermediary, BEI will require a higher level of equity and greater access to long-term funding.	The government should review the rationale for the creation of BEI and recognize that if it is to be a lead institution in the recovery of trade finance, it will need a significant increase in its capitalization. The decision that BEI would not compete with commercial banks should also be revisited and the role of BEI be expanded. A study should be undertaken to assess the feasibility of BEI becoming a forfaiting house.
Many of the current credit insurance and export guarantee programs are overly restrictive and hence are underutilized.	The government should create an inter-agency commission to review the terms and conditions of the state-led credit insurance and export guarantee programs. Ineffective and duplicative programs should be eliminated. A new set of export-related programs, which more closely follow international standards, should be designed. Efficient systems, which allow credit and policy coverage approvals on a 'blanket' basis, as opposed to transaction-by-transaction, should be developed.
A major problem for trade finance is the lack of legal basis for the use of many commonly accepted international financial instruments to secure or transfer title of movable goods.	The government should follow through on its plan to pass a new law on secured transactions and financial instruments. This law should allow companies to utilize international standard trade documents and warehouse receipts as proof of title to inventory and goods in transit. Ease of title transfer and the enforceability of seizure in the case of default should also be incorporated in the new law.
Because of inappropriate bank regulations and weak legal environment, there is a lack of utilization and acceptance for the more modern forms of trade finance instruments.	BEI should lead the development of operational systems for the use of warehouse receipts, financing through forfaiting, and other financial instruments commonly used in other countries.